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No. 01-603

IN THE

Supreme Court of the United States

DELUXE CORPORATION,
Petitioner,

v.

FRANCHISE TAX BOARD,
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of California, First Appellate District

BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITION

STEPHEN P.B. KRANZ *, Tax Counsel
DOUGLAS L. LINDHOLM,
President/Executive Director
DIANN L. SMITH, General Counsel
WILLIAM D. PELTZ, Chair
BOBBY L. BURGNER, Vice-Chair
J. HUGH MCKINNON, Counsel
Lawyers' Coordinating Subcommittee
COUNCIL ON STATE TAXATION
122 C Street, N.W., Suite 330
Washington, D.C. 20001
(202) 484-5221

* Counsel of Record

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BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITION

INTEREST OF THE *AMICUS CURIAE*

The Council On State Taxation (COST)[1] submits this brief as *amicus curiae* in support of Petitioner in the above captioned matter.[2] COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities.

[1] COST was previously the Committee On State Taxation but changed its name to the Council On State Taxation by vote of its membership November 6, 2001.

[2] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioner and Respondent has been obtained and filed with the Clerk of the Court.

COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of approximately 550 multistate corporations involved in interstate and international commerce. COST's members' interest in this case is both specific and general. All COST member companies either do business in California or are subject to corporate income tax in states with statutes similar to those of California.[3] Specifically, COST members hope that the Court will clarify the Congressional intent of Public Law 86-272,[4] and prevent California from indirectly imposing taxes on income of multi-jurisdictional taxpayers (via the unitary business theory) which it is precluded from doing directly (via Public Law 86-272). Without such guidance, States will continue to run afoul of Congress's overt efforts to facilitate interstate commerce.[5] Because of the unique impact of Public Law 86-272, this case presents the Court with the opportunity

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[3] We are aware of five other states (Arizona, Indiana, Kansas, Utah, and New York) that follow California's lead by ignoring the rule of Public Law 86-272. *See Airborne Navigation Corp. v. Ariz. Dep't of Rev.*, No. 395-85-I, 1987 Ariz. Tax LEXIS 34 (Feb. 5, 1987); Ind. Dep't of Rev., Informational Bulletin No. 12, 1988 Ind. Tax LEXIS 27, June 1988, *revised* Nov. 1993; Kan. Dep't of Rev., Kan. Rev. Rul. 12-91-1, Kan. St. Tax Rptr. ¶ 18-735, Feb. 1, 1991; Utah Admin. Code 865-6F-24. New York is currently litigating the issue.

[4] Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified *as amended* at 15 U.S.C. § 381 *et seq.* (1994))

[5] As this Court noted in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), Congress has explicit Constitutional authority to regulate interstate commerce. Even so, Congress rarely exercises its prerogative, and, other than Public Law 86-272, has not given the states guidance on the taxation of multistate businesses. In such a near vacuum, states cannot be allowed to ignore the authority Congress *has* given.

to interpret the interplay between Constitutional and federal statutory law not presented in *Citicorp N. Am. Inc. v. Franchise Tax Bd.*[6]

In the instant matter, the key inquiry before the Court is whether California is able to abandon its general rule of tax determination (solely because one or more members of a unitary group are protected from income tax under Public Law 86-272), and apply a scheme that taxes income Congress has explicitly protected. The Franchise Tax Board, operating without sufficient guidance from this Court, has rendered the statutory tax jurisdiction concepts powerless as applied to a unitary group. Its action subjects income protected by Public Law 86-272 to tax by assigning the income to members of a unitary group that have nexus in California. By doing so, California violates the Congressional protection for interstate activities. Further, despite this Court's holdings regarding retroactivity of judicial decisions, California has unilaterally applied its judicial decision interpreting the function of a federal statute on a prospective basis only. *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86 (1993); *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971). By granting the Petition for Certiorari, this Court can reassert the validity of the Congressionally enacted safe harbor of Public Law 86-272 and can establish proper standards for inclusion of income consistent with federal and constitutional limitations on the states.

SUMMARY OF THE ARGUMENT

Public Law 86-272 limits states' ability to tax income from outside their territorial boundaries. States may subject a multi-jurisdictional taxpayer's income to tax if the

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[6] 83 Cal. App. 4th 1403, 100 Cal. Rptr. 2d 509 (2000), *cert. denied*, ___ U.S. ___, 121 S.Ct. 2623 (2001). The facts in *Citicorp* are similar to the facts of the present case except for the monumental difference that the taxpayer in the present case is protected by Public Law 86-272 whereas the taxpayer in *Citicorp* did not have such federal statutory protection.

income arises from a unitary business; however, states such as California may not use the unitary business theory to circumvent a federal statute that otherwise explicitly protects the income from taxation. The fact that an entity is unitary with a group of entities does not, *a fortiori,* render the entity taxable in each state where any member of the group has nexus. To reach such a conclusion is to transmute unitary theory into nexus theory. Both legislative and judicial histories overwhelmingly establish that the federal statute, Public Law 86-272, is precisely geared towards protecting multi-jurisdictional taxpayers in this exact scenario. Recently, a somewhat similar matter was brought before this Court in *Citicorp*, but the taxpayer in that case did not have the benefit of Public Law 86-272 protection. In the present case, the statutory protections cannot be understated. Public Law 86-272 is the result of the recognition by Congress, as well as decisions by this Court subsequent to the passing of the statute, that the states' interest in taxing certain business activities is weaker than the national interest in promoting an open economy. *Heublein, Inc. v. South Carolina Tax Commission*, 409 U.S. 275 (1972). Confounding matters further, California has inconsistently applied its interpretative decisions concerning Public Law 86-272. In 1966, California first adopted the "Joyce" rule holding that the income of protected members of a unitary group would be excluded from the apportionment factor. *Appeal of Joyce, Inc.,* No. 66-SBE-069 (Cal. St. Bd. of Equal., Nov. 23, 1966). Then, in 1990, California switched its position and applied new analysis that *included* the income protected by Public Law 86-272 in the apportionment formula of a unitary group. It chose to apply this ruling retroactively. In 1999, in another about face, California readopted its original ruling but applied this analysis *prospectively.* Such treatment is not only arbitrary but has also caused great uncertainty among taxpayers. Therefore, this Court's guidance is needed to validate and reassert the power of Public Law 86-272 when states attempt

to use the unitary business doctrine to circumvent it, and to clarify whether the Franchise Tax Board properly applied its 1999 judicial decision prospectively in its interpretation of Public Law 86-272. Such guidance would reestablish needed certainty for the compliance and return preparation efforts of multi-jurisdictional taxpayers who have come to rely on the well founded principles Congress adopted in Public Law 86-272.

ARGUMENT

I. CALIFORNIA CANNOT UTILIZE THE UNITARY BUSINESS PRINCIPLE TO CIRCUMVENT THE CONGRESSIONALLY CREATED INCOME TAX SAFE HARBOR OF PUBLIC LAW 86-272.

A. By enacting Public Law 86-272, Congress unequivocally intended to end the uncertainties surrounding taxing jurisdiction nexus standards by creating a national safe harbor.

The Commerce Clause limits a state's ability to tax a nondomiciliary corporation's multi-state income. U.S. Const. art. I, § 8, cl. 3. Consistent with these constitutional limitations, a state's ability to tax income earned by a multistate business requires a "minimal connection" between the interstate activities of the corporation and the taxing state. *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-437 (1980) (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978)); *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1954). Public Law 86-272 originates from the great uncertainty that developed in 1959 from the multitude of definitions which constituted a "minimal connection." *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959) (holding that nexus existed where taxpayer rented an office in the state in which it solicited sales); *Brown-Forman Distillers Corp. v. Collector*

of Revenue, 234 La. 651 (1958), *appeal dism'd*, 359 U.S. 28 (1959) (holding that nexus existed where taxpayer neither rented nor owned property in the taxing state and only occasionally visited the state); *International Shoe Co. v. Fontenot*, 236 La. 279 (1958), *cert. denied*, 359 U.S. 984 (1959) (holding that nexus existed where taxpayer neither rented nor owned property in the taxing state but regularly and systematically solicited orders for sales).

Within months of the decision in *Northwestern*, and subsequent refusals by the Court to disturb the Louisiana Supreme Court decisions in *Brown-Forman* and *International Shoe*, Congress responded to the "considerable concern and uncertainty" and "serious apprehension" in the commercial community, and passed Public Law 86-272. *Heublein*, 409 U.S. at 279. The Court, in *Heublein*, recalled the Congressional concerns as follows:

> Persons engaged in interstate commerce are in doubt as to the amount of local activities within a State that will be regarded as forming a sufficient . . . . connection with the State to support the imposition of a tax on net income from interstate operations and 'properly apportioned' to the State.

Id. at 280, n.5 (quoting S.Rep. No. 658, 86th Cong., 1st Sess., 2-3 (1959)). Despite the historic reluctance of Congress to entertain federal legislation in the area of state taxation of interstate commerce, the magnitude of the concern to erase the existing uncertainties prompted Congress to assert its authority to regulate interstate commerce by passing Public Law 86-272. Public Law 86-272 establishes that a state may not impose its income tax upon the income of a taxpayer whose only activity carried on within the state is solicitation of orders for the sale of tangible personal property, if these orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside

the state.[7] Since 1959, multi-jurisdictional taxpayers have relied on the settled expectation that activities falling within the confines of the statute may not be the subject of a state tax measured by their income. This expectation has guided tax return preparation and compliance efforts of taxpayers in every state. California, and states that follow its lead, should not be allowed to simply ignore when Congress acts (rare as it is) to protect interstate commerce.

B. California circumvents the Congressional safe harbor under the guise of the unitary business principle.

California does not dispute that the activities of Deluxe's subsidiaries and the resulting income fall within the protections of the statutory parameters of Public Law 86-272. Nevertheless, California ignores the federal statute and seeks to subject the protected income to taxation by assigning the income to the members of Deluxe's unitary group that do not have federal protection. Such a scheme is the result of the California's view of *Appeal of Finnegan Corp.*, No. 88-SBE-022-A (Cal. St. Bd. of Equal., Jan. 24, 1990), which was formally adopted by California Franchise Tax Board Notice 90-3, dated June 8, 1990 (hereinafter the "*Finnegan*" rule).

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[7] Public Law 86-272 provides in relevant part: "§ 381 Imposition of net income tax. (a) Minimum standards. No state or political subdivision thereof, shall have power to impose . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following: (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

Under this scheme, California is able to utilize an "alternative apportionment" when the general apportionment formula results in income being assigned to an entity within the unitary group but protected by federal statute. The "alternative apportionment" then attributes such income to those entities within the unitary group that are not protected by federal statute. Were the state to respect the protection afforded by Public Law 86-272, it is clear that the group's California tax liability would be significantly less than it is presently. The result of California's approach in the instant case, therefore, is that California has imposed tax directly on income that it is not allowed to tax directly. *See Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458, 468 (2000). Similar to the result in *Hunt-Wesson*, California has taken the position that it may assign ***all*** unitary business income to entities over which it has jurisdiction, ignoring that some of the income should properly be attributed to other members of the group which it is statutorily precluded from taxing.

The Constitutionally based unitary business principle is strictly a theory of apportionment. It was not meant to be a blanket rule of jurisdiction to tax. In the instant case, all business income of the unitary group, which is comprised of Deluxe and its subsidiaries, form the apportionable tax base. To respect Public Law 86-272, California either must exclude the protected members' numerators from the apportionment formula or must designate a reasonable portion of the resulting apportioned base to the protected member and thus exclude it from tax. California refuses to follow either method just described, and in the process, circumvents the purpose and principle of Public Law 86-272. The issue is not one of apportionment but whether California can tax the income of federally protected companies. If the Court allows this practice to continue, Public Law 86-272 will eventually be rendered useless and the business community will be subject to the compliance problems and uncertainty that existed in 1959.

Congress adopted Public Law 86-272 long after this Court began applying the unitary business principle. See *Adams Express Co. v. Ohio State Auditor*, 166 U.S. 185 (1897). If Congress had intended to limit Public Law 86-272 protection to stand-alone businesses, Congress could easily have done so in the statute. Rather, the statute as written provides absolute protection from taxation for qualifying entities and their income, including those entities that are part of a unitary business. California cannot include such protected income in the numerator of the apportionment formula or assign the resulting tax base solely to taxable members of the unitary group in clear violation of Public Law 86-272.

C. California's vacillating interpretation of Public Law 86-272 subjects taxpayers to inconsistency and punishes out-of-state companies.

Underlying the problem in the instant case is that California has announced a change of its rule twice since 1966 and has applied the changes retroactively and prospectively in an inconsistent fashion designed to disadvantage out-of-state taxpayers. For 24 years, since California first established the Joyce rule, the standard in California was that receipts of entities not taxable by California, such as those protected by Public Law 86-272, were not included in the numerator of the sales factor of California's apportionment factor. The *Joyce* rule, however, was reversed in 1990 by the *Appeal of Finnegan Corp.*, which included in the numerator the sales of all entities in a unitary group, including those entities that were protected by Public Law 86-272. For nine (9) years thereafter, California's practice was to overlook Public Law 86-272 and to circumvent the protection it afforded to qualifying entities of a unitary group by including their receipts in the numerator of the apportionment formula and assigning their income to unprotected members of the group. Furthermore, California applied the *Finnegan* rule retroactively to taxpayers with tax years open under the

statute of limitations. The retroactive application of *Finnegan* was intended to punish out-of-state taxpayers by allowing the State to assess tax on income of entities protected by Public Law 86-272.

In 1999, in *Appeal of Huffy Corp.*, No. 99-SBE-005-A (Cal. St. Bd. of Equal., Sept. 1, 1999), California reversed itself and restored the *Joyce* rule in favor of the problematic *Finnegan* rule. California, however, arbitrarily refused to apply *Huffy* retroactively, as was the case with *Finnegan*, but rather applied *Huffy* prospectively only. The practical effect of the prospective application of *Huffy* was to mandate taxpayers to file franchise tax returns under a methodology California has acknowledged as improper and an incorrect interpretation of Public Law 86-272. In addition, California used prospective application of *Huffy* to continue the disadvantage imposed on out-of-state taxpayers under *Finnegan.* With regard to the instant case, California's seemingly endless quest for revenue from out-of-state companies has created a paradox where the Deluxe subsidiaries in question correctly filed their tax returns in 1988 and 1989, pursuant to the *Joyce* rule, (which would currently be considered correct pursuant to *Huffy),* but the returns are considered incorrect under California's retroactive application of *Finnegan.* The nine (9) year *Finnegan* aberration catches taxpayers such as Deluxe in an inequitable and uncertain position and presents to this Court the vital opportunity to assess the unitary business theory as retroactively applied in disregard of Public Law 86-272.

The California Court of Appeals, in *Citicorp*, reviewed the validity of the prospective treatment of *Finnegan* and declined to disturb the decision in *Huffy* to remain prospective. That court, though, neither offered its own analysis of the issues nor considered the impact of Public Law 86-272. The court properly recognized that the general rule for judicial opinions is that they are fully retroactive and that

civil decisions "must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate the announcement of the rule. *Citicorp*, 83 Cal. App. 4th at 1422 (citing *Harper*, 509 U.S. at 97). Accordingly, the court identified the following factors when not following the general rule and dealing with the issue of nonretroactivity:

> First the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed . . . the second factor considers whether in light of the 'history, purpose, and effect' of the rule in question its operation will be furthered or retarded by retrospective application . . . the third factor weighs the 'inequity imposed by retroactive application' and whether it would produce . . . substantial inequitable results, . . . injustice or hardship.

Id. at 1423 (citing *Chevron*, 404 U.S. at 106-07). In applying these factors to the decision in *Huffy*, the Court of Appeals stated that a new principle of law had been established; however, this so-called new principle was one that had been in effect for the previous 24 years under the *Joyce* rule. This is hardly a new principle but rather the restoration of an older principle. Arguably, the *Finnegan* rule *could* have been applied nonretroactively, but California chose not to do so. It should not have such a choice with respect to *Huffy*. The Court of Appeals further stated that the second factor had been met since the history, purpose, and effect of the *Finnegan* rule was an attempt to lead a movement towards uniformity; however, the presence of Public Law 86-272 demonstrates the real impetus of *Finnegan* was to attempt to alleviate the scenario where entities of a unitary group would have otherwise protected income. Finally, the third factor supports prospective application if there are substantial inequitable results from retroactivity. The Court of Appeals

only looked at Citicorp's refund opportunity; rather, the court should have looked at taxpayers currently under audit or with open tax years, and at the inequitable results where *Finnegan's* application serves to circumvent Public Law 86-272. In the instant case, California twice applied its decisions to the benefit of the State Treasury and detriment of out-of-state taxpayers, and has not sought to prevent inequities from its disregard of a direct federal statute.

In *Harper*, this Court restricted nonretroactivity further than in *Chevron* when the judicial decision involves a federal law. *Harper*, 509 U.S. at 100. In *Citicorp*, the Court of Appeals declined to apply the analysis asserted in *Harper* because the issue, in *Citicorp*, only involved constitutional nexus. There was no federal law to be interpreted. In the instant case, the presence of Public Law 86-272 serves to further restrict nonretroactivity and, consequently, absolutely distinguishes this petition from the petition in *Citicorp*. Review by this Court is warranted by the violation of Public Law 86-272 and by California's changing position on the issue.

COST is concerned that if this Court allows California to vacillate on its application of the rules, with ***no*** underlying change in the statute, the administrative agency responsible has license to mislead the public, change its legal position at will, and suffer no ramification.[8] Having twice interpreted the taxing statutes to provide for a *Joyce* approach to unitary groups, California cannot be allowed to impose retroactive application of the *Finnegan* rule when such an approach

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[8] California is not the only state guilty of such behavior. Rather than dealing with its own error prospectively, the Michigan Department of Treasury retroactively assessed taxpayers that had relied on two Revenue Administrative Bulletins promulgated by the department when the Michigan Supreme Court, *sua sponte*, determined that the bulletins were incorrect. *See Gillette Co. v. Dep't of Treasury*, 497 N.W.2d 595, *cert. Denied*, 513 U.S. 1103 (1995).

violates Public Law 86-272 and the state's obligation to interpret the *Finnegan* rule consistent with the underlying, and unchanged, statutory scheme. The presence of Public Law 86-272 demands that the *Joyce* rule, as reasserted and restored in *Huffy*, be applied retroactively.

CONCLUSION

For the reasons stated above, COST respectfully requests the Court to accept this case for review and prohibit states like California from circumventing Congressional action by assigning all income of a unitary group to those entities over which the state has jurisdiction, contrary to a specific federal statute. States can not be allowed to usurp Congressional authority by misinterpreting the (only significant) federal statute on state taxation passed by Congress to protect interstate commerce.

Respectfully submitted,

STEPHEN P.B. KRANZ *, Tax Counsel
DOUGLAS L. LINDHOLM,
President/Executive Director
DIANN L. SMITH, General Counsel
WILLIAM D. PELTZ, Chair
BOBBY L. BURGNER, Vice-Chair
J. HUGH MCKINNON, Counsel
Lawyers' Coordinating Subcommittee
COUNCIL ON STATE TAXATION
122 C Street, N.W., Suite 330
Washington, D.C. 20001
(202) 484-5221

* Counsel of Record